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Local Government Borrowing: Regulation and Practice Country report - Romania

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I. Introduction

The public administration restructuring process was initiated immediately after the removal of the Romanian communist regime in December 1989. Upon the adoption of the Law on local public administration (Law no. 69/1991, replaced in 2001 by the Law no. 215), the Law on local elections and articles 119 and 120 of the new Constitution in 1991, the necessary legal framework was elaborated in order to foresee a real public administration reform process. One of the direct consequences that were expected was related to the transfer of more power/managerial responsibilities from the central to the local level, where the public administration is, by nature, closer to the citizens. Both the Constitution articles and the Law on local public administration are based on the following fundamental principles of the European Charter of Local Self-Government (ratified by Romania later 1997): local self-government and decentralization, financial autonomy, eligibility of local authorities, citizens' participation and the appropriateness and legality of the local authorities' decisions. A real autonomy of local communities has occurred upon adoption of other important laws, such as the ones related to local finances: Law on local taxes and charges (no. 27/1994) and Law on local public finances (no. 189/1998). In addition, normative acts that regulate important areas regarding the public administration activity were adopted: Law no. 81/1999 regarding public debt or Emergency Ordinance no. 60/2001 regarding public acquisitions. It has to be mentioned that, although the legal framework in the domain of decentralization has been adopted, there are still many challenges related to its implementation some of these challenges described in the current report.

In order to fully understand the legislative and administrative background in Romania, we will briefly go through the main relevant aspects. Romania is divided into counties (judete), towns (orase) and communes (comune), whose boundaries are established by law. A county structure consists of a capital (municipiu resedinta de judet)¹, several municipalities (municipii) and all towns and communes within the county's territorial boundaries. Certain towns are classified as municipalities. Although there are no legal regulations in terms of public administration institutions or policies to distinct towns from municipalities, the main existing criteria are: territorial size, number of inhabitants and historical background, socio-cultural importance (the term *municipality* will be used in the report to name the specific administrative territorial units). Bucharest Municipality is a particular case as it has subdivisions (sectors), each of them being able to designate the district councils and mayors. Romania is divided into 42 counties (including Bucharest Municipality), 262 towns and 2,686 communes. The communes together comprise 13,000 villages. There are two levels of local government: county level and local level. The local level consists in local self-government units of municipalities (municipii), towns (orase) and communes (comune).

According to the Romanian legislation, communes, towns, municipalities and counties are legal entities that may own public and private property. They

have full authority and responsibility in all matters related to administrating the local public interests within their established territorial units. In order to provide a real public autonomy, local authorities can determine and approve revenue and expenditure budgets for which they can collect local taxes and charges.

The local public administration institutions through which local autonomy is implemented in the local communities are the local councils as deliberative authorities and the mayoralities as executive authorities. County councils with deliberative prerogatives and the president of the county council, as the executive authority are the representatives of county government. It has to be mentioned that there is another administrative institution at county level, the Prefecture that mainly supervises the legality of local governments' actions. The prefect is the representative of the government at the county level.

According to the Law no. 70/1992 regarding the local elections, local and county councils are elected on the basis of the party list system through direct suffrage, while mayors are elected on the basis of a uninominal system in two rounds. The local councils, the county councils, the mayors and the General Council of Bucharest Municipality are elected by universal, equal, direct and freely expressed suffrage. Last local elections were held in June 2000.

Regarding the relation between central government authorities (the Prefecture) and local authorities as well as the relations in general between different levels of local authorities (county and local level), the legal framework on public administration in Romania includes very precise references. According to the Law on public administration (2001) there is no subordination between the prefect and local authorities. At the same time, there is no subordination between the county public administration and the local one, according to the law. The relations between them should be based on autonomy, legality and cooperation aiming to solve the issues of common interest.

In reality, in both of the above-mentioned cases, there are different aspects that make the insubordination principle more a desiderate than an obligation for the functioning of the local administration. For instance, the prefect has the responsibility to supervise the legality of the normative acts issued by local authorities within the county he is appointed in. At the same time he can take legal action against local authorities if he considers that the normative acts are illegal. Domestic and international analysts expressed their concern about the political interference in the administrative decision making process that was registered in a significant number of localities all around Romania.

A more clear "dependency" is the one regarding the relation between the president of the county council and the rest of the local authorities within the county. The "dependency" is mainly related to local budgets' constitution and distribution. The president of the county council is responsible for the distribution of the equalization funds to the local communities within the county². Although many analysts have indicated that there is a political subjectivism in the distribution of the money in the territory, further in-depth researches would be relevant.

Currently, the local administration reform process is guidelineed, apart from the Law on local public administration, by the following key laws:

- ? Law on local taxes and charges empowering the local governments to establish, collect and administer certain taxes and fees (no. 27/1994);
- ? Law on local public finances (no. 189/1998), providing a new framework for local finance mechanism and strengthening the local financial autonomy; this law was followed by subsequent modifications through other laws and governmental ordinances and its newest revision is currently under debate;
- ? Law on public domain and its legal regime (no. 213/1998), addressing the issue of asset allocation between central government and local government and the distinction between property in the public and private domains; however, this law's implementation has proved to be difficult and there has not been significant progress on its implementation since its approval;
- ? Law on concessions (no. 219/1998), setting the general framework for concessions at the local government level;
- ? Law on autonomous enterprises' (regii autonome) reorganization (no. 103/1998) and Law on commercial companies' privatization (no. 44/1998), transforming autonomous enterprises into commercial companies, transferring shares of local utilities to the corresponding local government units and setting rules for their privatization.

Other laws that are very important are expected to be soon issued, which shows that even the legislation is still under improvement.

In spite of the French experience, Romania public institutions (at all levels) were undoubtedly one of the first areas that went through intense transformations immediately after the fall of the communism. Obviously, the reform process is far from being accomplished as it takes a lot of time to enforce serious transformations in a domain that for so many years was used that decisions and permission to act come only from the top. On the other side, although it has to be said that first democratic laws were initiated short after the regime change, such profound reforms in the area of the public administration could not be limited to changing the law. It continues to be a challenge for Romania society to step further from the legislative adoption phase towards implementing it and training the public authorities representatives (elected, appointed, hired) to serve the community interests only.

Once the major pieces of the legislation regarding the public administration functioning (Law on local public administration, Law on local public finances) were adopted, the most problematic task was to assist local authorities to understand their new financial responsibilities, and - even more important - the

completely reversed relation with the central authorities they were used with as a “tutor”.

From all provisions of the law on local public finances for example, it becomes now easier to understand why local authorities have more frequently complained about the equalization funds (percentage and criteria) than about legislation to allow them try other financial tools (borrowings, credits, etc.). It is of course due to most of them very unfriendly local economic environment that they were claiming an increase of the central government transferred funds. It could be though a matter of mentality, and a still existing culture of dependency that need more time to adapt to the new trends and reality.

It is thus very important to encourage a constant and substantial implication of the local authorities in Romania in any legislative revision that might concern them which is, it has to be said, happening more and more systematic these days, with all complains of the local authorities if not being sufficiently involved in the legislation decision making process, especially when referring to local finances.

More exposed to international experiences of neighboring and West European countries, local authorities were very active during the last years in advocating for the elaboration of the legislative norms to allow them contracting loans from the banks.

The central government receptiveness towards elaborating new legislation to help local authorities become financially more self-sustainable was also being important. There are still many provisions regarding additional mechanisms to improve the local budget, main first steps were made. It remains to fully correlate all legislation regarding local public administration functioning and local public administration financing with the institutions' reform (management) to be able to professionally implement it and supervise its application.

Decentralization is the key concept of the public administration reform in Romania today. The process is irreversible and will lead to major changes and to a new Romania. Local public communities will act independent and self-responsible for their decisions and financial management but they can not act as if they belong to a separate world than the central government. Legislation should first reflect the local communities needs, implementation capacities as much as it would need to try to constantly adapt to European standards.

Reforming the public administration, giving more responsibilities but also more financial autonomy to the local communities (which some might still consider as a loss of authority and influence of the central government) should be strongly helped by a committed political will. It shouldn't mean the implication of politics in the administrative decision making process (Romania being many times decentralized through this weakness) but it needs to be politically supported at all levels.

Ultimately, the application of the new legislation on financial self-autonomy, and other means the local public administration could use to supplement its

local revenues, is depending on the local implementers: the self-confidence of the local authorities that they will not fail if trying other mechanisms than the state transfers, the experience, the strong relation with the business community, the relation of the executive branch with the legislative one at the local level, the assistance of the central government in correctly going through all the necessary steps.

It is obvious that the new practices (local borrowing, etc) were perceived as “extravagant” by mayors/local authorities at their first mandate and very positive by more experienced local authorities. New means transformation, and Romania local authorities can adapt, and will easier do so by being extensively exposed to those local authorities who succeeded (both in the country and abroad).

II. Presentation of financing local government mechanisms

2.1. General aspects

As previously mentioned in the report, the local public administration in Romania includes two levels of government: a local level (which includes communes, towns, and municipalities) and a county level. Each level has distinctive own revenues and competencies (expenditures) according to the adopted legislation and reform strategies.

Local public administration in Romania is managing approximately 4% of GDP (the percent increased from 3,5% in 1994 to 4,7% in 1996, while in 1999 decreased until the level of 4%. The same situation as 1999 occurred in 2002).

During the first years after 1990, the annual Law on the State budget was considered the basis in the drafting and implementation of the local administration financing policies. Those provisions in the State budget law were perceived as reflecting a high degree of centralization of the decision making process and a lack of budgetary predictability for the local level, the situation being considerably improved in time. The State budget law is annually adopted and it includes information about the equalization funds allocated to the counties. The budgets spending are preliminarily assessed after the first half of the year. Normally, additional funds are wired to the local communities with this occasion.

A separate discussion concerning the so-called “special funds” is annually intense while drafting the State budget law. These “special funds” main role is to assist local communities with funds for investments projects they are insufficiently able to finance. The “special funds” are earmarked revenues of the local budgets managed by the ministries. They are established through a Decree issued either by the Romanian Government or the Parliament. Special funds are formed of the special taxes paid by the direct beneficiaries; they should be established and collected with a concrete aim and for a specific project and implemented in a certain period of time. In 2002 the main special funds were: the Fund for Health Social Insurance, the Special Fund for Developing the Energetical System and the Special Fund for Public Roads. The criteria and the distribution are up to the ministries. One example in this sense is the Special Fund for Public Roads, managed by the Ministry for Transportation, an institution often criticized for insufficiently transparent implementing distribution criteria.

The Law on local public administration and the Law on local taxes and charges were both considered a progress in strengthening the local communities’ autonomy and creating new sources of revenues for the local governments. Many issues related to fiscal decentralization remained unsolved, like for example the transfers’ allocation system had not reached the transparency that was required.

The administrative reform has continued after 1991, with a significant crossroad in 1997 - 1998; at some point analysts agreed that it was even accelerated in the sense that key financial policies that changed the structure of public finance as well as fiscal relations between central and local authorities were implemented.

A balanced allocation of central versus local responsibilities was one of the Romania young democracy challenges. In a sense it still is, only the areas recently sent to local management changed. The issue has slower become even more complicated as the necessary decentralized financial resources were claimed. Year after year, the challenges became more critical, several major steps being undertaken in 1997 - 1998 due to the following main reasons:

- 2 A visible external influence on post-communist governments coming from international financial organizations, donors or European Union in

order to immediately implement the necessary public administration reforms in this domain;

- 2 Central government faced permanent budget constraints and therefore decentralization of responsibilities appeared to be a must.

On the other hand a series of factors generated a rather “half way” financial decentralization reform:

- ? The concern of the central administration regarding the rather weak institutional capacity of the local public administration, regarding the possibility of fraud and municipal bankruptcy, public debt and increased budgetary disparities, all these concerns slowing the initial planned reform timing;
- ? The still existing paternalist attitude of the central government towards the local one, not yet perceived as an equal partner of the central government, regardless the law provisions in this respect.

Fiscal decentralization was initiated along with the adoption of the Law on local taxes and charges (1994). The law clearly stipulates that local taxes and charges are forming the local communities own revenues; their rates are decided, collected and controlled by local governments. Thus, the charge on property became the main source of own revenues of local communities in Romania. During 2002 the law was amended in order to facilitate the local government own revenues increasing.

The Law on local public finances was issued in 1998 and the role of the local budgets became more important from this year. The law regulates the transfers between different levels of the government, the equalization funds' role as well as the local government borrowing. A mathematical formula for assessing the financial capacity of the local governments was established in order to help the central government correctly distributing the equalization funds. Several other indicators were used in the equalization decision making process (e.g. the length of the streets, the number of high school and secondary school students, etc). The equalization of the local budgets is both made from the nation level to the county level and from the county level to the municipalities, towns and communes within one community. Although stipulated in the Law on local public finances, the indicators as well as the place of the financial capacity formula in the whole equalization process are annually revised in the context of drafting the State budget law.

The Law on local public finances also includes an appendix on the budgetary classification that must be followed by the local administration while administrating the own budgetary revenues and expenditures. The adoption of the law changed the whole approach, local communities after 1998 being given a share of the percentage of the income tax collected in their community. Earmarked transfers allocated to autonomous enterprises or to public services and investments were eliminated. An equalization system that aimed to correct expenditure and fiscal capacity disparities among counties/local communities was also elaborated.

The key aspect the law is approaching is the strengthening of the local fiscal autonomy while clarifying and expanding local control over revenues and formation of the local budgets. Although the establishment of an equalization system has been an important step towards local financial autonomy, there were still problems that are mainly related to the transparency of the allocation of funds as well as to political interference in the financial decentralization process at different levels. Just to mention a few of these problems, it has to be said that the criteria for the distribution of funds to local level is annually modified while adopting the State budget law. At the same time, the key role in allocating the funds to mayoralities belongs to the president of the county council. The allocation of equalization funds often becomes a political negotiation rather than a result of an objective and transparent implemented criteria to fairly differentiate between local needs. Apart from the quite frequent accusations of political membership influencing the county council president relation with the local authorities in the process of allocating the transfers (a very hot topic in Romania but obviously not the central theme of the current report), it also has to be mentioned that consultations are part of the funds allocation process.

Similar to what should be the consultations (it will be correct to speak about negotiation) between the central authorities and the representatives of the counties, the president of the county council should consult with the mayors in the county, listening to their needs before allocating the funds. How often this happens, it is another very interesting area to research, keeping in mind the very personal character of the in-between public authorities relation in Romania.

The society modernization has constantly had an impact on improving the legislation. The legal framework has gradually improved from the '90s stage when the local budgets were regulated through the State budget law itself to the current more diversified and more issue-oriented legal framework.

The contribution of the 1994 Law on local taxes and charges is unquestionable but a real progress has occurred in the context of elaborating a Law on local public finances in 1998. It was this year that changed the approach, addressing the local budgets as part of a larger, comprehensive local budgeting unitary policy. Individual resolutions approach has turned into an articulated vision on local public finances in Romania. With creating a unique, articulated legal framework, after '98 improvements (although some still difficult to implement) were complementing it easier.

2.2. The structure of the local public administration revenues in Romania

Local public administration revenues include:

- a - own revenues
- b - transfers from the State budget
- c - internal and external borrowings.

A. Own revenues

In Romania the percentage of own revenues within local budgets' revenues increased during the last years, mainly as a result of the changes in legislation that allowed the decentralization of several sources of revenues. In 1995 own revenues formed 28% out of the local budgets' revenues at the national level. The percentage decreased during 1996 (22,61%), 1997 (18,95%) and increased again in 1998 (24,73%) as a result of the new Law on local public finances. In 1999 the consequences of the new law became quite visible as the own revenues reached 44,58% (a quota of the income tax being decentralized). During 2000 there was a slightly decreasing (36,28%) (see Chart 1)

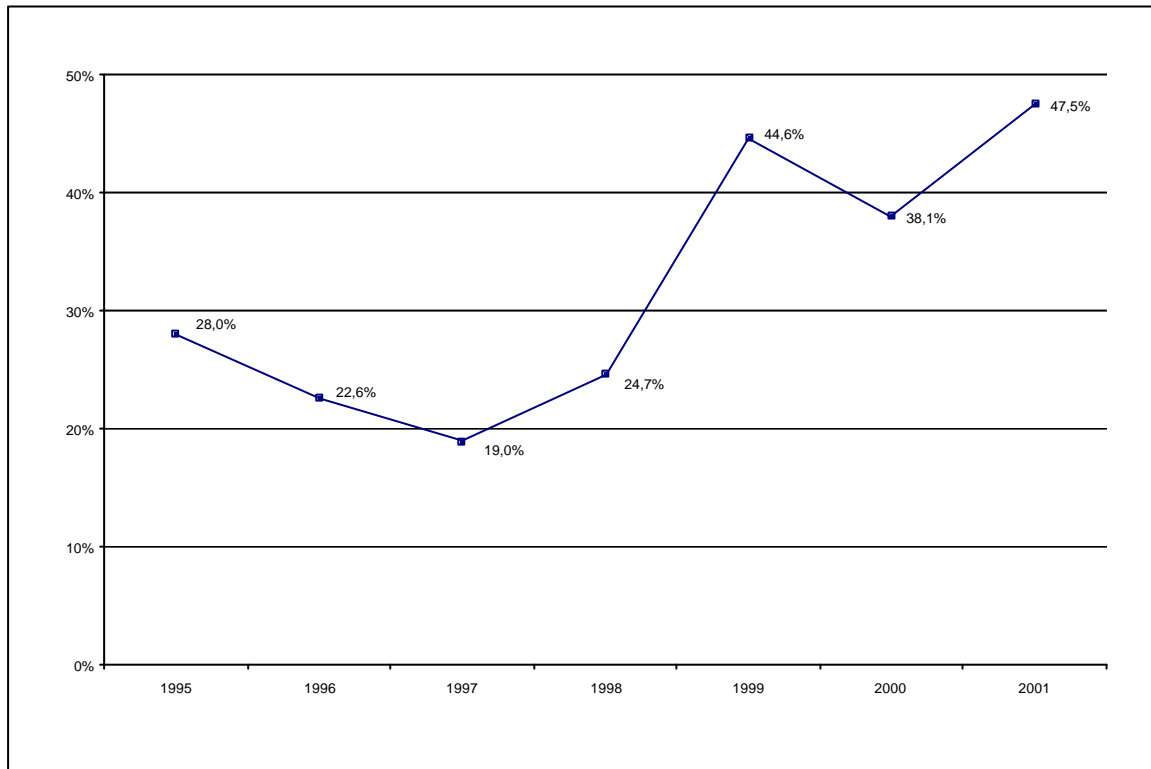


Chart 1. Percentages of the local government units own revenues from the total revenues of the local budgets

The distribution of the local revenues according to different types of local government units shows that the municipalities (municipii) are collecting the highest percentage of revenues from all the other types of local government units (see Chart 2). The main reason is that local economic environment plays a significant role in the formation of the local revenues and the municipalities have the most developed business environment from all the other types of the local communities in Romania.

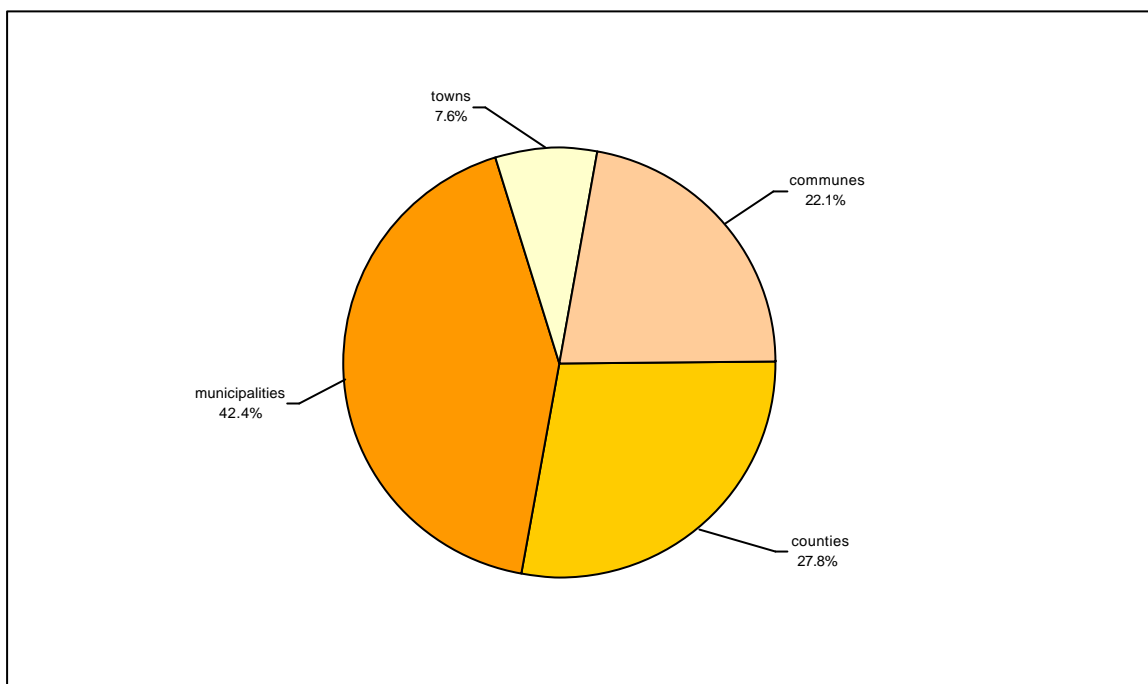


Chart 2. The distribution of the local revenues according to the type of local government units, in 2001

Own revenues include:

- ? Current revenues (fiscal and non-fiscal)
- ? Capital revenues
- ? Earmarked revenues.

✍ **Current fiscal revenues** are the taxes and charges collected at the local level, such as the property tax. The non-fiscal revenues are revenues coming from the profit of the private and autonomous enterprises as well as from the public institutions. It resembles with corporate income tax, only that in Romania it is not a tax and it is considered a non-fiscal revenue of the local budget.

According to the legislation, the own revenues are under the control and audit of local authorities. They are responsible for establishing the taxes and charges of the local communities as well as their level. The Audit Court is the institution responsible for local communities expenditures control at central level.

Local public authorities are directly involved in the establishment and the collection of taxes and charges and they can conduct their own fiscal policy depending on the status of local economic development, local needs, as well as their institutional capacity. The Law on local taxes and charges from 1994 had no limitation on the number nor the level of taxes and charges local authorities could establish. However, in 2002, after many local authorities have succeeded in increasing their local taxes with over 50%, the central government issued an Emergency Ordinance that established some maximum limits for main local taxes and charges (the ones regarding the buildings, lands, automobiles, issuing construction authorizations). There are

small variations between municipalities local taxes' rates in what concerns the main taxes (e.g. tax on property) but the funds raised from the local taxes also depend on the capacity and inventivity of local authorities to establish new taxes. These are just a few examples of local taxes established by local authorities:

- ? *The tax on questions* - Sibiu. According to the decision of the local council in Sibiu, a tourist getting lost while hiking has to pay 10,000 lei for every question he addresses to the members of the rescue team;
- ? *The tax on interviews* - Vrancea. The mayor of Tâmboiesti commune (Vrancea County) decided that each interview with the local authorities should be charged with 400,000 lei, funds that will help the local budget;

✍ **Capital revenues** - are generated by the assets' sales belonging to the private patrimony of the local public administration. They are rather exceptional revenues representing only a small fraction of the total local revenues.

✍ **Earmarked revenues** include special taxes³ that can be established in order to finance the public services. They represent an optional choice for local communities, not all of them accessing these type of revenues (under these circumstances, they are not currently substantial).

✍ **The quotas from personal income tax** - is a shared tax representing one important financial resource of the local budgets. The quotas from personal income tax is distributed to local public administration according to the Law on local public finances but the percentages may change every year upon the new provisions of the State budget law of that year. For instance in 2002 the personal income tax was shared between the levels of government as follows:

- 37,5% remained at local level after the tax was collected;
- 10% was allocated to the county level;
- 15% was transferred to county authorities that will further distribute it to local communities within the county, according to the respective year criteria provided by law;
- 37,5% belonged to the State budget.

The funds that local authorities receive from these sources are not earmarked but, at the same time, it has to be said that they don't prove to have the necessary tools to predict, establish or collect these resources. The deconcentrated departments of the Ministry of Finances collect them.

As already mentioned, a quota from the personal income tax is allocated to the county budgets according to the equalization criteria established in the respective budgetary year. At the same time, a significant bigger quota is allocated with the purpose of equalizing the rest of the local communities' budgets (municipalities, towns and communes). It is the responsibility of the county council president to distribute the equalization funds to the local communities within its county, following the same criteria in the equalization

system that was used when distributing the funds from the national to the county level. Currently, differentiating between the national to county equalization transfers' criteria and the county to local's is one of the most largely debated topics that is involving key institutions from all levels of the public administration.

B. Transfers from the State budget are:

- ? Grants and quotas from shared taxes
- ? Earmarked transfers.

✍ **Grants from shared taxes** consist in transfers from the personal income tax (the quota that remains at state level) and from the Value Added Tax (VAT). These funds can be:

- non-earmarked. They can be used by local authorities to fund any kind of expenditure;
- earmarked. The funds will cover subsidies for the price of the heat distributed to population or for covering salaries of the teachers in primary and secondary schools and for social protection. In this case local authorities do not decide their level or their destination.

✍ **Earmarked transfers** are Government's contribution to the projects international organizations it is required to contribute, to the financing of the activities and services regarding medium and long-term investments of local communities.

C. Borrowings

Local government borrowing represents the most innovative tool for increasing investment revenues of the local public administration in Romania. It was for the first time in 1998 that the new Law on local public finances comprised several regulations in this respect. Thus, the local public administration can use two instruments of borrowing: loans from commercial banks and bond issues. *The Romania experience of internal local borrowing will be approached during the following chapter of the present reports.*

Local government units also have access to external borrowing. When contracting external loans, the local communities must have the approval of a Commission mandated to authorize and approve the loans (the Commission is formed of representatives of the local public administration, the Government and the National Bank of Romania). This procedure is followed if a certain amount is exceeded. This maximum amount is periodically updated. The members of the Commission meet monthly and they assess all requests coming from the local government units. The Ministry of Finances can guarantee an external loan contracted by a local government unit. In this case the Ministry will supervise the contracting procedure as well as the reimbursement of the loan. The current report does not include details about

the external loans of local government units, the specific procedures and institutions involved requiring a separate research.

2.3. The structure of the local public administration expenditure in Romania

The expenditures of local public administration open another very important chapter in the discussion about public administration reform and local autonomy in Romania. In order to fully understand the implications, special attention should be paid to the way responsibilities are also shared between different levels of the government.

The daily practice in Romania shows that central authorities have the tendency to maintain the control over the level and the structure of local administration expenditures. A study of the Partners for Local Development Foundation shows⁴ that there are at least two explanations for this tendency: the macroeconomic stability and the fact that central government still plays an important role in financing the decentralized responsibilities. Local public administrative units continue to act as agents of the government while dealing with some public services. Central authorities have transferred the management of public services to the local level and later some of the financial resources but local authorities are still not in charge of adopting important decisions regarding the quality of the respective services. For instance, the teachers' salaries responsibility was transferred to the local communities along with the financial resources but the local authorities still cannot decide the number of teachers in a school or the number of schools in their community in order to better plan the management. These decisions belong to the county department for education, the deconcentrated governmental institution.

In 2001, local public expenditure reached the highest level (36,4%) out of the total public expenditure (see Chart 3). In 2002 it represented only 35%.

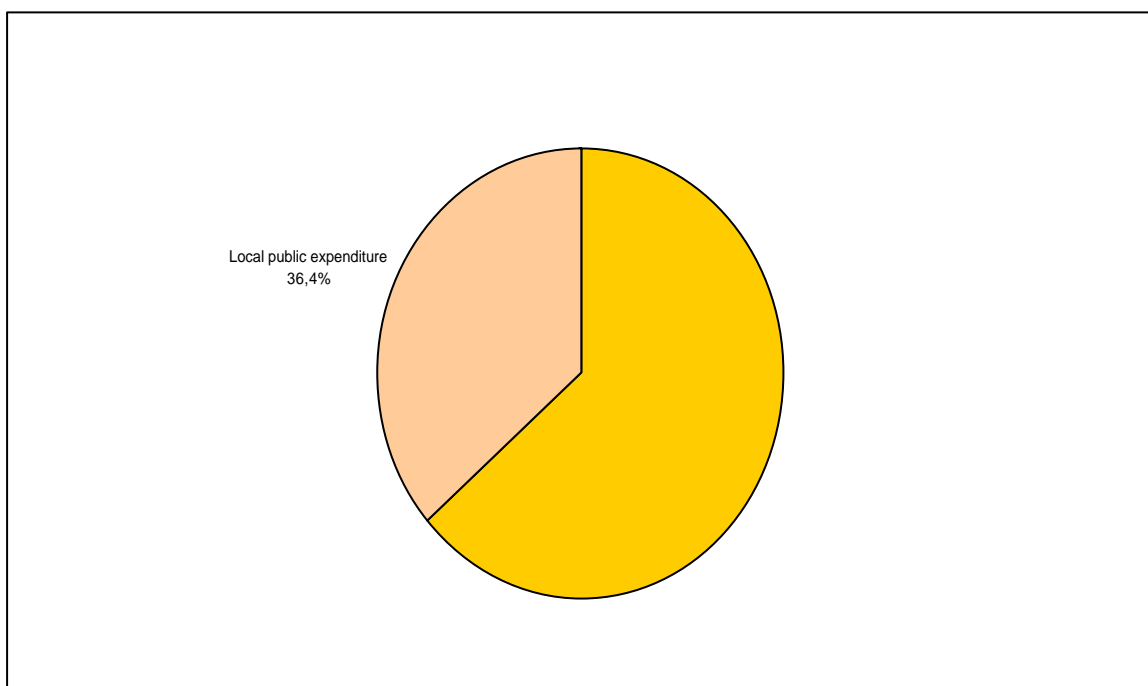


Chart 3. Local public expenditure out of the total expenditure in 2001

2.4. Forms of funding local capital investments

Investment budgets of the local communities are very different from one community to another. The direct consequence of this situation is the very different stage of development projects.

Until 1998 investments at local level were financed through earmarked transfers (utilities for water providing and water waste, heat units, roads and bridges, housing, utilities for gas providing, etc.). These transfers were eliminated when the Law on local public finances was passed in 1998 when investments, in which context were being financed either through own revenues or borrowings.

Although the transfer of responsibilities regarding investments financing is a positive step towards a real local autonomy, problems occurred after the adoption of the Law. Many local communities had insufficient financial resources to support the investments (unlike the central government, which was in full capacity) so, generally, they didn't get involved in investment projects until the new financial instruments were created.

In order to have an overview on capital expenditure according to each type of local community, the following chart contains their percentage out of the total expenditure in 1999 and 2001 (see Chart 4).

During 2001 the percentage of all types of capital expenditures of local communities decreased due to a weak synchronization between the transfer

of fiscal resources versus the responsibilities that were delegated to the local level. At the same time, local authorities couldn't afford to invest in development programs because the expenditures for the newly delegated social assistance and protection projects were using a very important share from the local budgets.

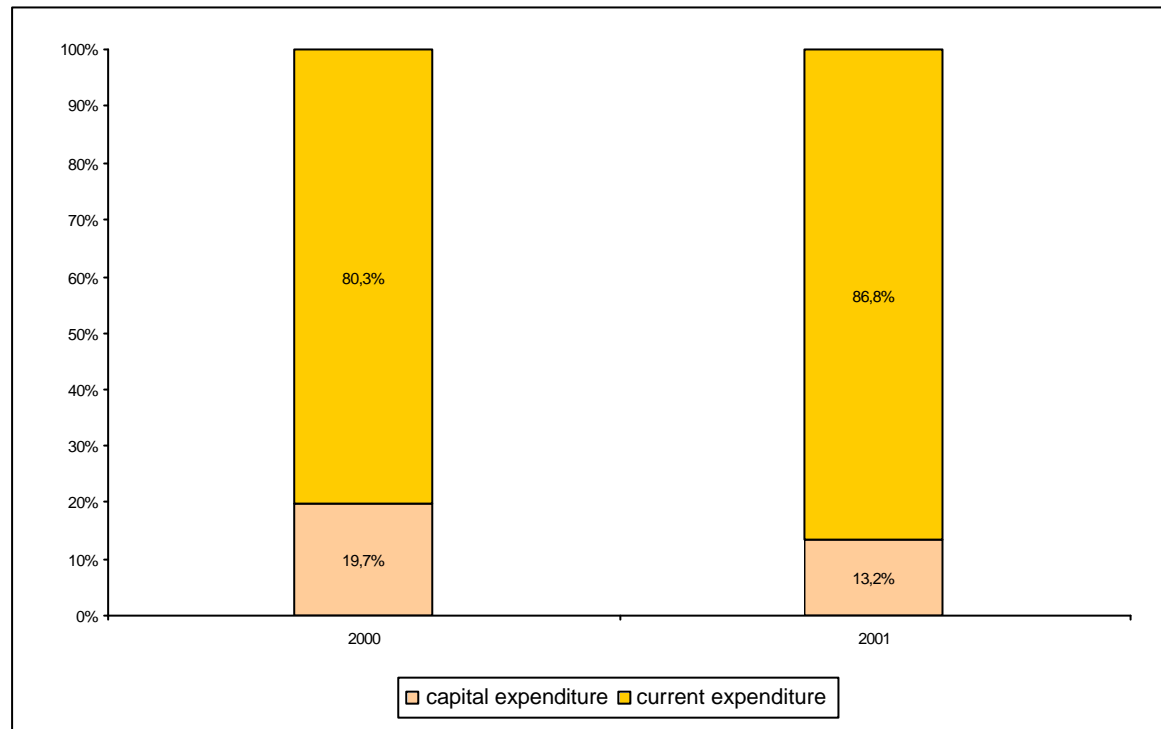


Chart 4. The fluctuation of the capital expenditure vs. current expenditure in 2000 and 2001

Capital expenditure for local development can be financed through:

- ? own revenues. Local communities will elaborate their own fiscal policies, according to the law provisions;
- ? grants based on following criteria:
 - the contribution of the local public administration to the formation of the public resources,
 - the level of expenditures for public services financing;
- ? internal and foreign resources (credits, bond issues, grants, non-reimbursable borrowings).

The distribution of the capital expenditure according to different types of local government units shows that municipalities (municipii), being the most developed out of the local government units, have the highest level of the capital expenditure (47,4%), while towns have the lowest one (8,9%) in 2000. During 2001 the situation is approximately the same (see Chart 5).

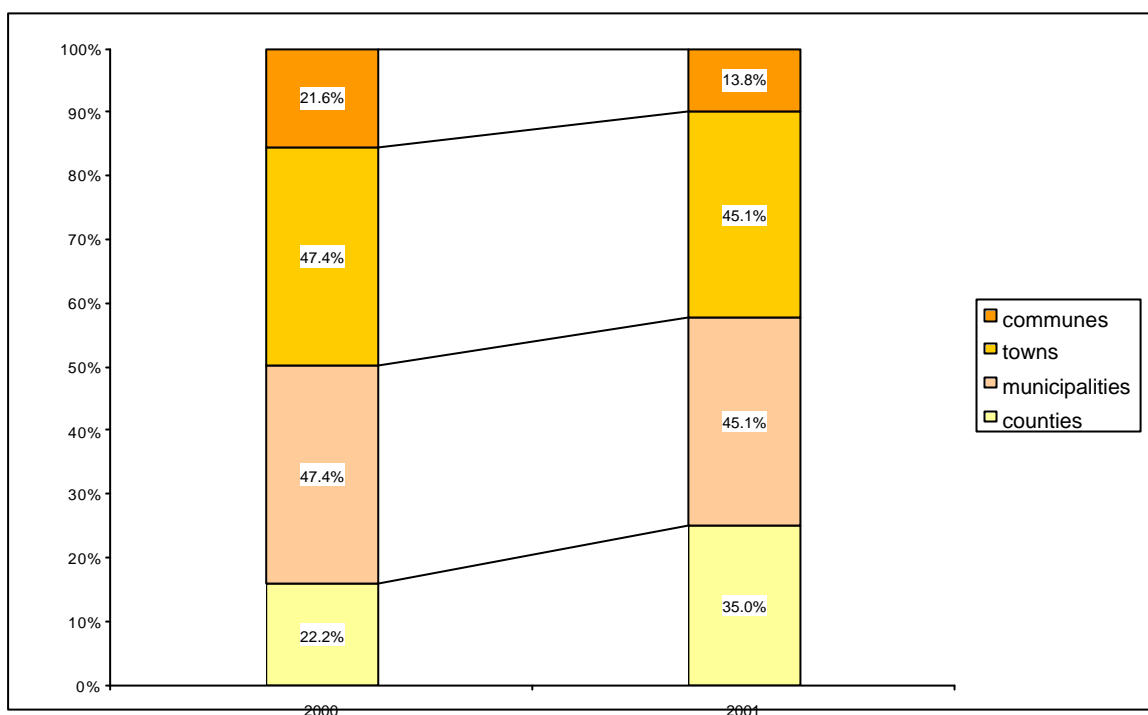


Chart 5. The distribution of the capital expenditure according to the types of local government units in 2000 and 2001

The reform of the local public finances system is definitely moving further and might reach new dimensions once the local public authorities representatives (Local Authorities Federation in Romania) will stronger defend their needs. Obviously, the first years after 1998, Law implementation has lead to a number of conclusions. These conclusions reflecting the reality in the country as well as the more articulate advocacy of the Local Authorities Federation and other independent groups, made the central government to consider evaluating the opportunity of some more modifications of the Law on local public finances during 2003. Local public authorities are mainly advocating for a larger financial autonomy as well as for a correlation between fiscal decentralization and responsibilities' assignment.

Recommendations:

- ? Fiscal decentralization process should be accelerated in order to allow stability and predictability of the local budgets. One immediate step could be to increase the income tax quota with 37,5% that is allocated to local communities;
- ? Objective criteria should be adopted while distributing the equalization funds. The financial capacity formula should be eliminated while clear indicators should be set up (e.g. the level of the average wage in a community). The criteria used in the equalization system should be stated in the Law on local public

finances, these criteria should not vary every time the State budget law is adopted;

- ? Local government units should directly address the Ministry of Finances in the process of allocating the funds, while the presidents of the county councils should no longer intermediate the distribution of the equalization funds;
- ? The Law on local public administration should include more clear provisions regarding responsibilities' assignment between different levels of governance especially in the case of the shared responsibilities;
- ? The local communities' budgets should be created on a multi-annual basis to better contract and manage the long-term investments;
- ? The traditional budgeting elaboration (through which one year budget relays on the previous one's revenues and expenditures) should be replaced with other more updated, programs oriented budgeting mechanisms.

III. Local government borrowing in Romania

3.1. General regulations and practices of local borrowing

The very incipient stage of implementing the local borrowing methodology in Romania leaves us more room for further detailing the relation between the current regulations and the institutions' performance to respond the market needs. Still, several relevant examples will help the further description.

From all last years' statements, establishing a local government credit market seems to become a future high-priority policy issue in Romania. With a delay of more than 10 years Romania is now ready to follow its neighboring countries' experiences such as Poland, Hungary, Czech Republic, whose strong economic and political will at that time, back in '90s, favored an important local development over the years. The following factors could in-short describe the background of improving the legal framework for municipal credit market development in Romania:

- ? Over the past decade significant responsibilities have been assigned to local government units. However, there has not been a sufficient effort to match responsibilities with available resources, e.g. disabled and handicapped support, child protection, and capital expenditures for schools. Local communities are facing an increasing burden when undertaking the required capital investments that are necessary in order to provide local services at appropriate standards.
- ? The central government has limited resources available for capital investments. The central government need to preserve the macroeconomic stability will directly affect the transfers and grants coming from the State budget. Central authorities' strategy towards encouraging the development of the local borrowing consists more in a re-evaluation of the legislation rather than the allocation of grants for local capital investments.
- ? Accession to the European Union (EU) will require a massive investment in environmental cleaning, much of it in landfills, incinerators, water treatment plants and other facilities at the local level. As in other countries aspiring to join EU, the Romanian public sector will have to significantly contribute in these investments, helping to meet the twenty-five percent (25%) country match required for obtaining EU preaccession grants. Developing the ability to leverage local investment resources through access to private debt financing will be a precondition for local government units to contribute with their share to the local public services' undertaking.

The very few practices in the area of local government borrowing have showed that the responsibility primarily belonged to the local authorities but that their success was also depending on the central government assistance. One of the main conclusions of the present chapter is that the current legal

framework in the area of local government borrowing needs substantial improvement. Local authorities' associations have already drafted concrete proposals that would improve the necessary legislation equipping them with more appropriate tools in order to more successfully contract borrowings. Central government, on its turn, is analyzing the opportunity of amending the legislation, looking at the institutional implications both at the central level (Treasury's role, banks' role, etc.) and the local level.

In this legislation reviewing process, the very enthusiastic examples of the local authorities that, despite the risks and sometimes financial and legislative instability, have decided to contract borrowings make us believe that commitment is really very important. It is still hard to speak about widely spread local borrowing practices in Romania but those few examples are relevant enough to evaluate what would be the minimum conditions whenever deciding to contract loans. The local practices of Romania indicate that legislation is only one very important factor that needs to be in place. The local authorities commitment, a long-term strategy, good predictability of the revenues and future years spending and local authorities' will to help the community grow (thus contracting the necessary funds to invest in the development projects) are only a few other conditions that also need to be fulfilled.

The legal framework regarding local government borrowing

Upon the adoption of the Law on local public finances in 1998 establishing the basic principles regarding municipal borrowing in Romania, the local government units can contract loans and issue bonds. First local government units' loans were contracted in 1999 after the adoption of the methodologies regarding the Law's implementation. 2001 was the year when the local communities issued the first bonds. Other aspects regarding the local government borrowing are stipulated in the Law on public debt (no. 81/1999) as well as in different other normative acts like Orders issued by the Ministry of Public Finances such as:

- ? Order no. 291 (2000) regarding the calculation of the debt service;
- ? Order no. 7 (2001) that decides who are the individuals excepted from municipal bonds taxation;
- ? Order no. 1631 (1999) regarding the obligation of the local public authorities to send information about local government borrowings

All this intense legislative activity shows that visible progress, which required constant legislation improvement was made.

The provisions of the Law on local public finances apply to loans and bond issue procedures. It is the responsibility of the local and/or county council to approve internal or external medium and long-term borrowings that concern their respective community. According to the legislation, the mayor or the president of a county council, as executive authorities of the local communities at each of the two levels, are responsible for the implementation of this decision. In practice, the mayor and/or the county council president initiative of issuing bonds is often easily approved by the local/county councils

as the last full responsibility belongs to the executive level. No doubt that the personality of the mayor/the county council president and his previous managerial experience are other important factors that have an impact in the deliberative process.

The law stipulates two main instruments the local government units can use while borrowing (bonds and loans from commercial banks). The borrowing destination is clearly regulated by law - the funds coming from a loan or a bond issue can only be used to finance local public investments and for the refinancing of the local public debt. Local public authorities in Romania see the funds raised through local government borrowing as one important source of financing their development projects, keeping the rest (the State transfers and the local taxes and charges) for daily operational costs.

The Law on local public finances also allows a temporary financing of the cash deficits through short-term borrowed cash from the available funds in the State Treasury (Art.53, (1)). Whenever these situations occur, the contractor (the local community) has to deposit the money at the Treasury. No deposits in commercial banks are allowed. This subject is one of the today most important negotiation topics between central and local government. In the context of still not sufficiently stable banking system in Romania, central government sees a too high risk that the local communities could be exposed to if depositing their funds at the commercial banks. On their turn, local communities claim more autonomy and pretend they should be treated as mature enough to distinguish between risky banks. Besides, bank's interest is considered to be an important, useful and additional source of income that the Treasury is not, by law, able to provide. When new negotiations between local and central government were held during February 2003, the local authorities reiterated this solicitation, emphasizing again the risks they were aware of but also the gains that became so important for their development projects the central government was less able to finance. The central government was still cautious, no change being accepted so far.

The internal borrowings can be contracted and managed by local authorities only, no support from the central government being required. For each internal borrowing the Ministry of Finances should only be notified by the local or the county council that decided to contract a loan or a bond issue. *The topic of notification is later detailed in the report.*

Central government has a legitimate interest that local communities do reach a balance between excessive debt and their own financial resources. Most countries accomplish this through a debt limitation. The Law on local public finances in Romania stipulates that the "annual debts representing the due installments deriving from contracted loans (...) shall not exceed twenty percent (20%) of the total current revenues of the local budgets (...)" (Article 51(1)). This debt limitation has been interpreted in the sense that the overall local debt *in any single year* shall not exceed twenty percent (20%) of the total current revenues of the local budget. Governmental Order no. 219/2000 specifies that the calculation of the debt service with a variable interest rate shall be based on the initial interest rate. At the same time, Governmental

Order no. 219/ 2000 also addresses the issue of calculation of the debt service within the debt limitation that is guaranteed by a municipality. The Order says that the entire local government guaranteed debt service shall be subject of the debt limitation. This provision is unnecessarily conservative. For instance, in case of the proposed fifteen-year loans offered by the European Bank for Reconstruction and Development (EBRD) to the local communities (without a sovereign guaranty), the local government has to provide guarantees that the debt will be reimbursed. In order to “secure” this guarantee, the municipality will be required to create a “reserve fund” that is equal to the amount of the annual debt service of the loan. In such case, when the debt has been fully reimbursed along the year, it seems unnecessary to include such a guarantee for the debt limitation. Additionally, as a result of the current restrictions on a commercial bank deposit, such funds would be uninvested for fifteen years. This will substantially increase the cost of financing. Furthermore, there are no executory procedures in place that the creditor can use in order to access such funds from the Treasury.

The Law on local public finances stipulates that long and medium-term loans may be authorized with the only purpose of financing the public investments of local interest or refinancing the local public debt (Article 48 (1)). This provision limits the municipal debt destination to infrastructure projects that are included in the “public domain” and sets an advisable “public purpose” standard for all local government credits.

Also, the Law on local public finances stipulates that Treasury short-term loans from the cash flow deficit financing shall not exceed five percent (5%) of a local government budgeted revenues (Article 53 (2), (1)). Additionally, the law stipulates that such loans shall not exceed the amount that the local government is able to cover during the respective fiscal year.

As repeatedly said in the report legal framework revision regarding local government borrowing is currently under debate, many of the above-mentioned issues being extensively discussed between main actors involved.

Recommendations:

- ? The maximum set forth in the Law on local public finances doesn't allow exceptions, should any local community plan to access more. Consideration should be given to a more permissive framework stipulate that, if certain criteria are accomplished (i.e. the own local revenue base can support a greater amount of the debt, creditworthiness indicators are better compared to the maximum level registered by the local government units of the same category), the debt limitation might be exceeded. Such a procedure for exception would allow: i) additional financing for more creditworthy municipalities, ii) financing of the investments that have a positive net impact on cash flow, e.g. energy conservation projects;
- ? The Law on local public finances should include more clear regulations regarding the calculation of the debt limit;
- ? Local government units should be allowed to make deposits at commercial banks. A step forward would also be the decision of the

central government to permit local communities to collect the interest of the deposits in the State Treasury;

- ? Consideration should also be further given to the possibility of eliminating the restriction of short-term debt that might finance only the “temporary cash deficits.” Local communities arguments in the favor of financing public investment projects with short-term debt should be more carefully analyzed. For example, they might either need this in anticipation of a long-term debt to be issued later, or to finance some preliminary costs of a public short-term investment project.

Monitoring and database regarding local government debt

The Law on local public finances stipulates “a municipality may contract loans only after the Ministry of Finances is informed about the intention” (Article 48 (6)). The law does not state when should the Ministry of Finances be notified and what should be the standard form of the notification.

Local government units are required to book all their debts and store the information in their annual accounting report (Article 52 (1)). The registry book shall include “details of such debt” and any other information required by the Ministry of Finances (Article 52 (2)). In the same context, the Ministry of Finances has issued Order no. 1631/1999 setting details regarding the information regarding the debt that should be included in the public registry.

Although legal provisions regarding data collection on local government borrowing are in place, in practice, the Ministry of Finances has no national database and therefore it has no national wide, clear image on the dimension of the local public debt is available to the public. Also, no detailed data about the local government units that contracted loans is centralized. In order to have an always updated national wide information about the local authorities’ experiences and capacity in the area of our interest, the role of the Ministry of Finances is crucial. A fluent exchange of information between the central and the local communities also needs to be in place, both parties transparently sharing their information. Always aware of the local financial capacity, the central authorities could better elaborate the appropriate financial development policies, which, in return, will bring more advantages to the local communities and will increase the cooperation between the two levels.

As the law provisions require, it is the primary role of the local authorities to inform central government on their situation regarding the local debt. Interviewing the central government representatives while elaborating the report, we have learnt that the representatives of the Ministry of Finances do not see a role in updating a national database with this information. One explanation could be that they are not sufficiently aware of their role in having a clear image on the nationwide local borrowing and of the importance of having a local perspective about how municipal borrowing system should be regulated. On the other hand, the local authorities perceive notifying and informing central government about their local debt and borrowing as an interference of the central government in their local autonomy and in the local decision making process.

Sensitive to European Union recommendations, central government has many times overreacted, acting excessively cautions when it came to demanding information/notification from the local government. Obviously, the concept of local self-governance is very differently perceived by many public authorities at different levels in Romania.

Except for the case of default on short-term debt or a over passing of the short-term debt limit, there is no monitoring of the municipal debt process. According to the current legislation, neither the local government unit nor the lender should notify the Ministry of Finances in case of a default. Consideration should be given to requiring a default notification in a public register to be stored at the Ministry of Finances and, of course, open to the public.

Closely linked to effective economic development and efficient use of public resources is the improvement of municipal budgeting and financial reporting practices. Preparation of local budgets and financial reporting are two important and intricately connected parts of the local fiscal management. In Romania, both processes are subject to strict national regulations. The local information plays a crucial role when drafting the State budget. A budget is line-itemed in order to clearly indicate the inputs (the financial resources) as well as the appropriate level of expenditures that need to be realistically planned. Local government fiscal information is based on the chart of accounts for budgetary (public) organizations. It is up to each local authority to describe in details the local financial report according to the information that it internally needs. All these detailed information should be integrated into the law requirements and limitations.

Budgeting and financial reporting are not just a set of procedural rules for spending public money but it could have a very important impact on the local development. A good structured budget may be used as a tool when implementing policies that are in accordance with local needs and reporting might serve as an instrument to provide feedback on outcomes of the policies. A sectorial or program type approach promotes allocative efficiency, i.e. allocation of resources from less to higher priority sectors or programs. Application of performance indicators or output indicators are closely linked to operational efficiency, providing information about cost-efficiency of the service provider units.

In short, local budgeting and reporting procedures in Romania are currently dealing with the following problems: (i) lack of strategic vision in the context of budgeting preparation process, (ii) lack of regional and sectorial perspective, (iii) current reporting standards that do not allow credit analysis (iv) limited access to comparative information on municipal finances and service delivery. The above-mentioned main problems are interconnected. In the absence of a clear strategy regarding the services delivery, the output (performance) criteria were not identified yet, no measurable service goals and standards being quantified if lacking performance indicators.

Most of these problems cannot be solved by simply introducing new regulations. Innovative approaches and methods should be disseminated throughout professionals and local practitioners. One possible option is to replace the current organization oriented, input-based budgeting methods with the output-oriented programs budgeting mechanisms. An important step in this direction could be to develop and introduce key service delivery indicators, to make sure that these are included in both the budget plans and in the annual reports and that information on outputs is fed back to the budget of the subsequent year.

Finally, another problematic area is the local government units fiscal data publicity and public accessibility. Information on the local municipal budgets and the budgets of municipally owned service providers, including balance sheets and property registration data, is centralized by the local offices of the Ministry of Finances. Although the government annually collects several hundreds of expenditure and revenue variables for fiscal monitoring purposes, this information is kept confidential at the national level. Only the Ministry of Finances has access to detailed local government units fiscal data. The existing data synthesized charts, although very important, are insufficient for any elaborated analyses on aspects regarding communities' financial capacities.

There is no legal obligation for the Ministry of Finances to transparently communicate the local governments' debt. The only requirement refers to the local governments whose budget has to be published in a local newspaper so that all citizens could read it. It also has to be mentioned that the requirement refers to the estimated budget and not to the executed budget.

Underlying the importance of publicity and accessibility to information regarding local public debt our recommendations are:

Recommendations:

- ? A special department should be established under the supervision of the Ministry of Finances whose responsibility will be to build and constantly update the database regarding local government borrowing. We would recommend that the Ministry of Finances requires the Notice that contains the same detailed of information to be included in the local government units public registry.
- ? Careful consideration should be given to the information required to be reported to make sure that all relevant information about the debt is included. In addition to the information required through the Order to be contained in the local government units' public registry, a certification of compliance with the debt limitation should be also solicited. Additionally, notification by both a lender and a borrower should, upon a payment default, be an obligation. Such information should be accessible to the public.
- ? This current inventory could also be annually updated, a special attention being regularly paid to improving local government units' debt reporting practices. Moreover, it could also be maintained as a public registry open to prospective lenders in order to assist them when underwriting the local government credits.

- ? Should any default on a local government credit occur, both the local community and the lender should be asked by law, to notify the Ministry of Finances over a certain period of time (e.g. in 10 days).

Regulations regarding the insolvency

As complex as it is and almost annually revised during the last years, the legal framework in Romania has no provisions to regulate the municipal insolvency situations. The Law on local public finances does have some remedial procedures that relate solely to the short-term loans owed in the Treasury.

Law and procedures need to be drafted soon to allow a better management of the local government insolvency as well as of its rights. The regulations should also stipulate which policies need to be in place in order to assist a local community in regaining a stable financial status. The central government, the local government units themselves, or the local government units' creditors should be able to initiate such procedures. The definition of local government insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged should be also very clearly stated. When interviewed about the policies regarding the medium/long term insolvency, most interlocutors have agreed that, if insolvency regulations would be adopted, the remedial procedures should primarily fall under the responsibility of the local authorities. Central government should have a limited role, more in the sense of assisting the local community.

In case of local community bond issue reimbursement incapacity, the law stipulates that each creditor of the municipal bonds should individually try to recover the money. Probably not a unique case, Romania experience has shown that it is in a way unrealistic to estimate that each municipal bonds' creditor will manage to individually recollect the bond funds. The legal framework should be amended to provide the creditors more appropriate tools to act in an efficient and organized manner, nominating a person that will further legally represent their interests.

Closely linked with insolvency is the creditworthiness of the local government units. Neither laws nor regulations require creditworthiness analyses or evaluations. Since the banks were not very active in contracting borrowings to municipalities, such analyses were conducted on a very casual basis. Only a few municipalities were undertaking such analysis, for their financial management purposes exclusively.

There are no local rating agencies yet to offer such analyses. Also, no international rating agency has provided a rating to a Romanian local government unit. Some years ago the city of Sinaia had tried to contract a such rating. The Mayor of Sinaia planned to issue bonds on the European market but, at that time, this was possible only after the approval of the Ministry of Public Finances. Despite the favorable perception on Romania in the Europe financial markets, the approval was not granted. The importance of a mutual beneficial relation between local and central government when it

comes to contracting a borrowing that we believe it is very important was earlier mentioned in the report.

Banks are involved in undertaking credit analysis as part of their internal rules since they became more and more interested (but at the same time still cautious) in working with the local government units. In most cases such rules are very little useful to a local government but more to a commercial company needs, given the fact that they are the most important clients of the commercial banks.

Recommendations:

- ? There is no clear legal regulation of the local government insolvency. Law and procedures should be developed for managing an insolvent municipality, its relationships and rights with regard to creditors. The definition of the local government insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged, should be very clearly elaborated;
- ? As the local government borrowing market develops, the independent rating agencies should be more active, their involvement contributing to further development of the local credit market in Romania;
- ? A set of policies to assist a municipality regaining a stable financial position should be drafted. Depending on the rules that are adopted, such procedures could be initiated by the central government, the local government unit itself, or, eventually, the local communities' creditors;
- ? The regulations regarding bond issues' creditors should be more clearly defined so that they would act in a more efficient manner while trying to recover their debt.

Guaranties for a local government borrowing

Analyzing the existing overall financial resources as well as the financial estimations regarding the local communities near future financial capacity, one can easily see that the largest source of local revenues is still represented by transferred central governmental funds. A number of countries use legislatively authorized "intercepts" of such intergovernmental transfers to enhance the ability of local governments of providing reliable safeness for their borrowings. Such intercepts can provide a strong incentive to the credit market development without any implied central government guarantee or additional "costs" of the Treasury. **Own revenues** thus represent the most used form of guarantee when referring to the local government borrowing.

The Law on local public finances stipulates that a local community has to guarantee with own revenues for any contracted loan, except for the case when the ultimate use of the loan could be also financed through earmarked transfers from the State budget (Article 48(3)). The Law on local public finances authorizes municipalities to pledge other transfers from the central government, e.g. quota and other amounts derived from certain incomes of the State budget.

Although the Law on local public finances does not include any provision related to securing municipal debt through **physical property**, the general principles of Romanian legislation would not prohibit securing municipal debt with a mortgage on local government property in the private domain. Although this may be a decrease of collateral source, it is a way to secure that the bank lenders are familiarized with this procedure, and it could have a role in the initial stages of bank lending to local communities. However, the Law on public domain, which will classify the “private domain” property that is eligible to be used as guarantee has not yet been fully implemented by the government, adversely affecting the ability of local communities to use physical property as a guarantee. A shift away from physical guarantees to general obligation and revenue secured debt may be a significant precondition for a sustainable development of a local government credit market.

The current legal framework has a foreclosure procedure that further decreases the value of physical property as guarantee. However, it should be noted that an amendment that became effective in January 2001, expedited the process of enforcement over movable assets (no. 99/1999). However, the foreclosure procedure for immovable or real property remains a time-consuming process.

Another form of guarantee is the **reserve fund**. It represents a financing device that sets aside an amount of funds, usually from the borrowing total. It is held separate from the other funds of the local government and it is available only for debt payments in case the local community will be unable to do so. In such case, the municipality is required to replenish the reserve fund in a well specified period of time. This device enhances the security for a debt instrument by providing a source of funding debt service payments in the case of cash flow disruptions that would otherwise result in a payment default on the debt. The Law on local public finances has no provisions that will allow or prohibit such security device. As we have already mentioned, certain local government guarantee programs require the municipal guarantor to create a reserve fund equal to the guaranteed annual debt service. However, unless such funds were permitted to be held in interest bearing accounts, the guaranteeing municipality would pay a substantial negative arbitrage cost, in addition to such reserve funds.

The Law on local public finances expressly states that the central government can guarantee the internal loans, if conditions, such as financial capacity of local government units, are fulfilled.

The Law on local public finances also stipulates that the “government may offer guarantees to external municipal “loans” in accordance with the terms of the Law on public debt” (Article 55). The Law on public debt authorizes the government to offer guarantees on debt issued in the domestic currency (Article 27). Despite all efforts to amend the Law on local public finances in such way so that the central government shall guarantee the domestic debt it was not changed. Discussions created nothing but confusion. Since the Law on local public finances does not prohibit such a guarantee and the Law on public debt clearly speaks about such a guarantee, it becomes the Ministry of

Finances' role to further debate the issue and identify the appropriate solution, harmonizing the provisions.

Private guaranties or insurance of municipal debt have been widely used to reduce creditors' risk and enhance municipal debt's creditworthiness. Private insurance companies insured almost half of all municipal bonds that have been issued so far for the on-time payment of debt service. Unlike free government guaranties, private insurances do not create "perverse" efficiency incentives. A premium is paid for guaranty coverage. A guarantor has well trained staff to assess the municipal finances risk or a project financing stability. The greater the risk, the bigger the premium that will be charged to obtain the guarantee. However, this is not a substitute for the local government creditworthiness, as the guarantors will only guarantee the debt of the community considered to be creditworthy.

Normally, lending banks in Romania get similar insurance from insurance companies guaranteeing the loan reimbursements. Further documentation regarding the possibility of developing this option for local government debt transactions is necessary.

Recommendations:

- ? Currently, most of the financial institutions require real estate guarantees and just a few accept that local authorities guarantee the loan with their annual own revenues. Many local authorities in Romania don't have a clear image on what is private or public property of local government. Only a Governmental Decree for each and every locality in this respect can establish the nature of the property. Under these circumstances, the procedures should be simplified and decentralized to the level of the local councils;
- ? A shift away from physical guarantees to general obligation and revenue secured debt is recommended as a significant precondition for sustained development of a local government credit market;
- ? Through specific banking mechanisms, the commercial banks should be encouraged to accept collateral forms of guarantee from the local public authorities;
- ? Local communities should be allowed to deposit the money coming from the local budget reserve fund at commercial banks, a supplementary guarantee being thus offered.

The role of the central government in the local borrowing process

Even in a decentralized public finance system, the central government retains a legitimate interest in the integrity of municipal budgeting and financial management. The first priority of a local government unit shall be to provide best local services to the community. A second fundamental priority is that municipalities shall prepare and execute balanced operating budgets. In order to oversight the municipal credit, the central government has one critical objective over ensuring compliance with legally mandated procedures and that is to limit the consolidated public sector's outstanding debt to comply with the international agreements, to preserve the government's ability to borrow from abroad, and most importantly, to build a solid base for the national economy and future participation in the European Union.

It is very important to protect the local government (and the central government indirectly) from the too imprudent loans that could threaten the safety of the overall public finance system and put pressure on the national government to deliver costly bailouts.

Still, under the existing circumstances, it is not advisable that the Ministry of Finances will be authorized to exercise prior restraint of municipal debt issuance. The Law on local public finances suggests a careful approach by not requiring the Ministry of Finances' approval for any municipal debt unless it is an external debt (as already mentioned, the Ministry of Finances has repealed a prior order that required approval of local government bond issues). A statutory debt limitation is used to decide a maximum "limit" of the debt that a local community can issue.

The heart of the rationale for private capital market development is the confidence that the self-interest of banks and other financial institutions will motivate them to assess the capacity of the borrowers in reimbursing their debts. To duplicate this function requires a sophisticated institutional capacity that the Ministry of Finances or another appropriate agency should develop. Even when this institutional capacity exists, there is little reason to believe that the monitoring agency will do a better job in assessing credit risks than the lenders or the rating agencies (or, for that matter, the communities themselves). Moreover, central government review and approval of local government credits can easily imply that there is the idea of an implicit guarantee, with municipal bondholders or lenders likely to hold the oversight agency responsible for any payment default.

The role of the central government in the new financial environment (in which more and more local communities are becoming interested in exploring other means through which to supplement their local revenues) is currently debated. Successful local authorities (financially independent, run by experienced local authorities) would expect no assistance from the central government, other than channeling the necessary information from top to bottom and vice versa. The ones whose experience is only now consolidating claim a more substantial support of the central authorities whose involvement they feel will bring more confidence that they ultimately would not fail. More than in other

domains, the financial assistance of the central government for the future self-sustained local communities is one very sensitive (even complicated) aspect of the transition countries facing very limited financial resources.

3.2. The scale of the local indebtedness

As already mentioned in the previous chapters, the local public authorities will not have access to any type of borrowing if the total annual debt (formed out of: interest to the already contracted loans, other interests and commissions including loans that are to be contracted) exceeds 20% out of the current revenues. The percentage will not change, should the size of the local government unit or the financial capacity vary. Some local authorities in Romania are advocating the Ministry of Finances to accept the idea of amending the legislation so that a city that is financially stable shall be allowed to borrow beyond the current limitation.

The ratio of debt service is calculated as follows:

$$\text{Debt service ratio} = \frac{\text{The annual debt}}{\text{Total current revenues}}$$

Periodical estimations on debt service ratio are needed as it can vary from one year to another. Through such regular estimations not only that the central government could be constantly aware of the size of the debt but also the most successful self financially developed local communities will, based on the gained knowledge, have more initiative and grow.

According to the Law on local public finances local communities can contract short, medium and long-term loans. In reality they now can contract medium and long-term loans only. As mentioned previously in the report, if local government units plan to contract short-term loans, they can only access funds from the State Treasury with the purpose of refinancing the cash flow.

Today, there is no available centralized data about the geographic distribution of the local debt. The information that exists conclude that, in Romania, cities and big towns are the local government units that, so far, contracted the most numerous and also most consistent (in terms of the borrowed amount) borrowings. No county council has accessed the internal market of loans or issued bonds for supplementing their own budgets so far.

Macroeconomical development has an important impact on Romania credit market and on the scale of the local indebtedness. Until present, the effects of macroeconomic indicators fluctuation on local borrowings couldn't be comprehensively estimated. The practice of local government borrowing is still in its early stages and there is no sufficient data to allow correlations. At the same time, it is obvious that the local borrowing process development is, in its turn, also directly influencing the macroeconomic growth or/and stability. It is in fact a double way process and the policy makers need to be aware of the inter-correlated relation.

In theory it is suggested that an increase of the inflation rate will determine a decrease of borrowings' rate. The related information on Romania case shows that there is an increased trend of the inflation rate as well as a decreased

trend of the interest rate. This might encourage the local authorities to access local borrowing because crediting will be stimulated.

Another important aspect that should be taken into consideration is related to the factors that contribute to the decision making process regarding the size of a loan or a bond issue to be contracted:

- ? the estimation of revenues and expenditures of a local government unit;
- ? the estimation of the resources that will be available after covering the operational expenditures;
- ? the net debt per capita;
- ? the experience of the local community in managing public debt;
- ? the available resources to allow the exploitation and the maintenance of the investment for which a loan is to be contracted;
- ? local public administration decisions should rely upon analyses regarding major economic and political aspects (especially in Romania where the legal framework is unstable, frequently amended);
- ? the willingness to accept the risk.

As for the supervision of the local borrowing process, the central government has two reasons of concern other than the compliance of local communities with the law:

1. The need to carefully monitor and limit the public debt in order to comply with international standards, while allowing the government to contract loans from international organizations. All these practices will create the premises for a more rapid but also professional European Union integration process. The consolidated national public deficit includes the deficits of all local budgets. In this sense, the public debt in Romania (it includes the national and subnational debt) was fluctuating as follows:

1997 - 27,7 %

1998 - 28,0 %

1999 - 26,67 %

2000 - 29,3 %

way under the limit of 60 % recommended by European Union.

2. The risky local communities borrowings may affect the integrity of the public financial system, forcing the central government to undertake "expensive" actions.

A consolidated financial environment, in which the practice of central government helping a local public authority loans' reimbursement incapacity, will strengthen the arguments based on which to assess whether legislation revision is necessary or not. It is true that, in its early stages of financial development, central authorities in Romania had to live and assess the daily experiences of different local communities going through the necessary process that lead to constructing a loan. Such experiences, no matter how difficult, shouldn't be replaced, their value being absolutely necessary when framing on the opportunity of changing the law. Based on the several already

lived experiences, some recommendations, (especially those regarding a better consultation between different levels of government, and the ones referring to a non-partisan central government assistance to the local communities) could be elaborated so that future weaknesses will be avoided.

Also, since these practices (loans, bond issues) are so new in Romania, more financially incapable borrowers among the local communities will naturally, directly affect the self-trust of the new potential clients. It is imperative that all interested will have free access to information, framing the others' experiences, while carefully assessing their financial capacity, along with being assisted by more experienced central government experts, whenever necessary.

Recommendations:

- ? The annual State budget law should include information about the local internal public debt. Currently it only includes information about the total internal and external public debt;
- ? Policies regarding local government borrowing should be periodically correlated with the existing macroeconomic situation;
- ? Consultations between different levels of government should become permanent in order to improve practices and avoid future failures in the local government borrowing process.

3.3 The debate about establishing the Investment Bank for Local Communities in Romania

Romania has no specialized institution in charge of managing or facilitating the local government borrowing process. At some point there have been discussions about creating the Investment Bank for Local Communities (IBLC), following the examples of different Western European municipal banks. In evaluating the opportunity of establishing a bank whose clients to only be the local authorities, the central government has analyzed the factors that will directly have an impact. Financial fluctuations will obviously be one of the main factors, Romania internal resources being insufficient for financing such a project. The cost of the capitalization (a serious potential burden for the local authorities still not financially stabilized) was the second major concern that has been deeply analyzed. The experience of other countries when capitalizing their Local Authorities Bank was studied, Romania Government and local authorities currently cumulating and analyzing all gathered information. Finally, the loans contracting criteria were discussed, preferential loans that could easily undermine the credibility of the whole initiative.

The idea of establishing an Investment Bank for Local Communities was generated by the many problems that local authorities were facing in the local government borrowing process. No doubt that such idea occurred as a compromise between local and central authorities, the local communities suggestion was that financial operations would no longer be exclusively managed by the Treasury, banks' responsiveness being perceived as more rapid and therefore much helpful. In order to fully analyze the possibility of establishing an IBLC, central government has had consultations with a number of foreign experts. The Dutch expertise and the Danish example were only two that were closely researched. From the two that the Romanian Government has had the intention of inspiring from, the Dutch one is perceived as being inappropriate for Romania of these days, mainly because the main responsibility in the capitalization process there belongs to the Ministry of Finances. The Danish example is still carefully assessed, some analysts expressing their concerns that the local authorities will expose themselves to too high risks in the process of becoming shareholders. The analytical process continues as we speak, with other still not fully answered questions about the main process' steps towards a proper capitalization, as well as about the role of the respective bank in relation with the rest of the State institutions.

The arguments in favor of establishing the Bank are related to: the deposit risk attenuation, a lower level of the interest rate, the possibility of contributing at the capitalization of the bank. Another aspect that will more stimulate local communities interest in contracting local government borrowings is related to the guarantees. In such new circumstances, the local communities could be able to guarantee only with their current revenues. At the same time, the bank could better represent the specific interests of the local communities and

could provide consultancy services that the commercial banks are not delivering today.

An important aspect that should be regulated refers to the relation between the capitalization process and the possibility of contracting a loan. The latter should not be directly dependent on the local administration capacity to capitalize. Political interference, which was perceived by many international analysts as being one dangerous characteristic of Romania democracy development, should be avoided. If not, small local communities and public authorities that have limited access to banking information will be disadvantaged.

Obviously, there are advantages and risks involved. Still, it is the general opinion that IBLC should not remain the unique source of available funds the local communities can access whenever borrowing. In parallel, the current commercial banks community should also be strengthened, as their services should continue to serve the local communities' needs. Local public authorities were positive about the project of creating the Bank. A research of the Institute for Public Policy in Romania implemented in July 2002⁴ showed that 92,6% of the questioned local authorities (over 80% of them answered to the questionnaires) were in favor of the project of establishing the Bank.

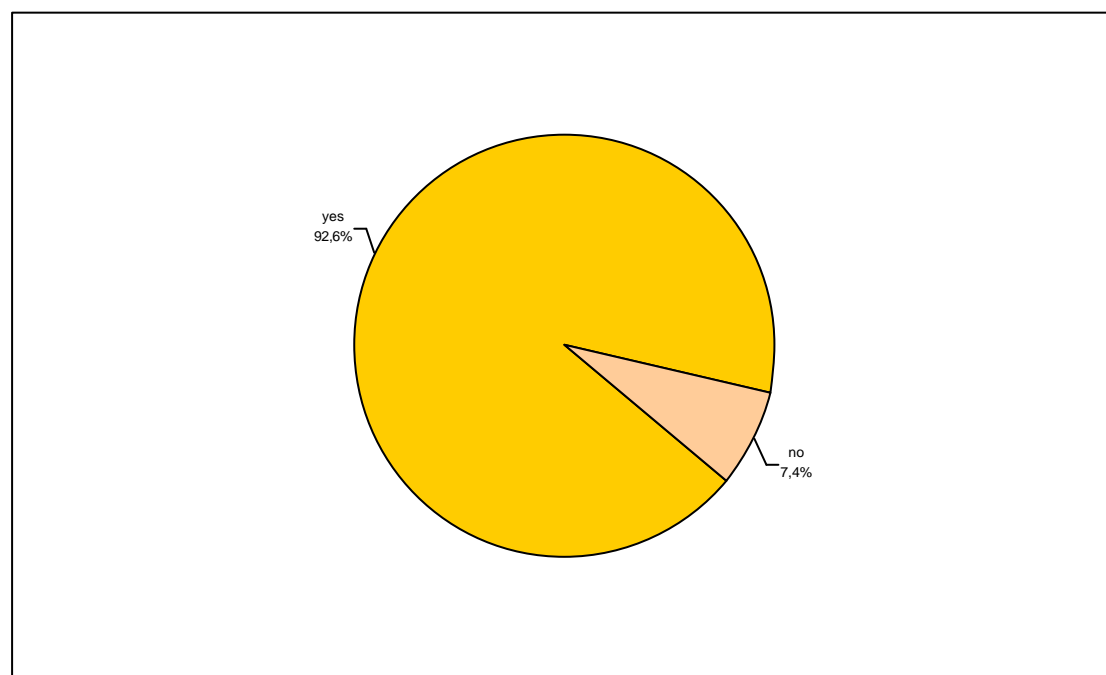


Chart 6. Do you think that the setting up of the IBLC is a good idea?

In the Romanian banks community, the temptation to subjectively allocate preferential loans is one other very sensitive, problematic area. It is crucial for a real development of the local authorities, based on respecting the principles of trust and mutual cooperation between all parties that the future IBCL will act transparently and professionally. No preferential loans, (generated by political

interference, clientelistic relations between the mayor and the bank delegate) should be approved so the Bank will grow as a solid and credible institution. Loans' procedures, methodology, obligations and rights should be well explained and widely communicated through all media channels around Romania.

Recommendations:

- ? Documentating the opportunity of establishing IBLC needs to continue to analyze all options;
- ? The decision about establishing the IBLC should not be taken without the consultation of all actors involved;
- ? If deciding to establish the IBLC, the access of local communities to other commercial banks should not be limited.

3.4. Specific aspects regarding bond issue

The specificity of the bond issue process requires a closer look to several other important aspects like: the profile of the underwriters and the role of the financial consultant.

Two Romanian banks have been the underwriters for most of the bonds issued in Romania in 2001 and 2002: Romanian Commercial Bank and Romanian Development Bank - Societe Generale Group. The major investors are the banks, the investment funds and the companies (shipyards, oil companies) and, to a lesser extent, the insurance companies. No pension fund has invested in municipal bonds so far. Also just a few of the underwriters are originary from the town or city the bonds were issued in. From this perspective it is clear that the citizens are not necessarily directly connected to the bond issue.

First local communities - banks joint bond issue projects were mostly initiated by the local communities. In time, banks have also become initiators approaching other local authorities, as they started to “enjoy” operating locally. The interviews with the bank representatives, whose opinions were considered relevant for the report, have showed that the two banks were really interested in this new type of partnership. Very concerned with the local authorities financial solvability and their capacity to meet the reimbursement deadlines, the banks admitted that these partnerships were and would continue to be one important part of the future development in Romania.

With some other new banks struggling to enter the market, the two mentioned banks became flexible and more receptive to local solicitations, their role changing in time, from a typical rigid loan provider to a flexible, consultancy provider partner, which, according to the local authorities that were also interviewed, improved the whole loans and bond issuing process.

The new role of the banks in the entire local financial development and financial decentralization process in Romania, raise new questions about the three partners’ relation (by partners meaning: the bank, the local community and the central government, the Ministry of Public Finances, this last institution’s role being constantly questioned).

The competition between the two banks that is very visible these days, will for sure increase the quality of their services and will reach a larger number of local communities, increasing the attractiveness of the two financial mechanisms (bond issuing and bank loans) more attractive to local communities.

Whenever issuing bonds the consultant’s role becomes very important. In addition to developing specific knowledge and staff within the local government units, most local authorities that issued bonds worked with an independent consultancy company. The consultant assists local authorities through the entire process of municipal borrowing. His contribution can be synthesized as follows:

- he analyses the indebtedness capacity of local government units and recommends the amount of money to be borrowed;
- he analyses other alternatives on the market: Treasury bonds, borrowing credits, external borrowing, etc;
- he suggests the optimum moment for a bond issue, the nominal value of the bonds, maturity rate and he also negotiates the interest rates;
- he estimates the macroeconomic trends and interest rates on the banking and capital market;
- he analyses the budgetary flow of local government units and makes predictions for the following years, etc.

The specificity of the bond issue process as compared to other financial mechanisms is primarily related to its deep economic nature. From Romania experience it can be affirmed that the bond market is less politicized and more transparent than the banking one. Also, the procedure for issuing bonds is less complicated than the one characteristic for contracting banking loans, the bureaucracy being considerably reduced in the case of the bond issue. Another element that makes the bond issue more attractive than the rest of the financial instruments is the fact that, due to the competition among the economic agents (most of the bond issues in Romania were oversubscribed) the interest rate is lower.

Bond issue is becoming a “popular” instrument used by local communities in Romania in their efforts to better support local investments. Still the procedure is not sufficiently regulated and further legislative steps need to be taken in order to facilitate an easier access to the bond market. At the same time, the practice is still insufficiently consolidated to be perceived as a trust-worthy mechanism of improving the local revenues.

Recommendations:

- ? The Law on local public finances should include a distinct section regulating the bond issue procedures;
- ? Legal provisions regarding bond issues should be correlated with the legislation regarding public debt and guarantees;
- ? Specific expertise should be further developed within the local public administration institutions, one suggestion could be the establishment of a loans and bond issue specialized department within the economic department of the local public authority.

3.5. Local policies on borrowing and debt management

Local government units' attitude towards borrowing

It was 1999 the year in which the local government units have accessed internal borrowing for the first time. That year and the one immediately after, most of the loans were small and their role was to co-finance the local investment projects. Focsani (one important city in the East of Romania) was the first local community that had contracted a loan from a commercial bank. It was a loan of 25 billion lei (approx. 192,000 USD at that time currency rate), contracted for financing the expansion of Moldova Market Place. Borrowing funds' is then to supplement the already existing but insufficient local revenues. Local authorities in Romania, still depending on the national allocated resources, are interested, but not necessarily enough equipped to take action in exploiting other routes leading to increasing their local resources, so that to be able to better finance their development initiatives.

During 1999 - 2000 just a few local government units borrowed funds with which they were supplementing their own revenues. State budget transfers and local taxes and charges are optimum for covering the operational costs, while investment projects require an additional financial support. The local authorities were cautious in taking risks as fiscal decentralization was also in its early stages, the local revenues still lacking predictability and stability. On the other hand, local government borrowing was also a novelty for the rest of the partners involved such as the banks. The banks were highly concerned that they wouldn't get any guarantee; the insolvency was not clearly defined in the legislation and the local communities were forbidden to make deposits at the commercial banks. Still, even in that quite risky environment, two solid banks decided to get involved (Romanian Commercial Bank and Romanian Bank for Development), becoming an active part of the local government borrowing process first stage in Romania.

In 2001, the first two local government units that issued bonds were Predeal and Mangalia, two small touristic towns (mountain and summer resorts). Eight other local communities followed them in 2002 and the "popularity" of the bond issues mechanisms has grown every year. Those that have succeeded immediately became an inspiration for the rest. Individual, direct consultations among the mayors have clarified the questions about whether to take "such risks" or not, a question that became so popular among the local authorities. Although not fully understood in its complexity, the mechanism of the bond issue is certainly a question to reflect upon for many of the local managers who are committed to develop the local community through attracting additional financial resources.

The research of the Institute for Public Policy in July 2002⁵ showed that 60,7% of the questioned local authorities answered "yes" to the question "Are you planning to initiate a bond issue during the following months?" (see Chart 7). In practice the results might be less optimistic, but it at least made the local authorities in Romania aware of how important it was to explore other means through which to supplement the local revenues and that issuing bonds could

be one possible solution. A local community needs to know that yes, it involves risks (many types of risks, sometimes almost uncontrollable) but it also requires its self-realistic evaluation of the local financial capacity at that moment and of the near future. At the same time, it requires vision as much as it involves pragmatism and a strong support from the final beneficiary of the project: the local community.

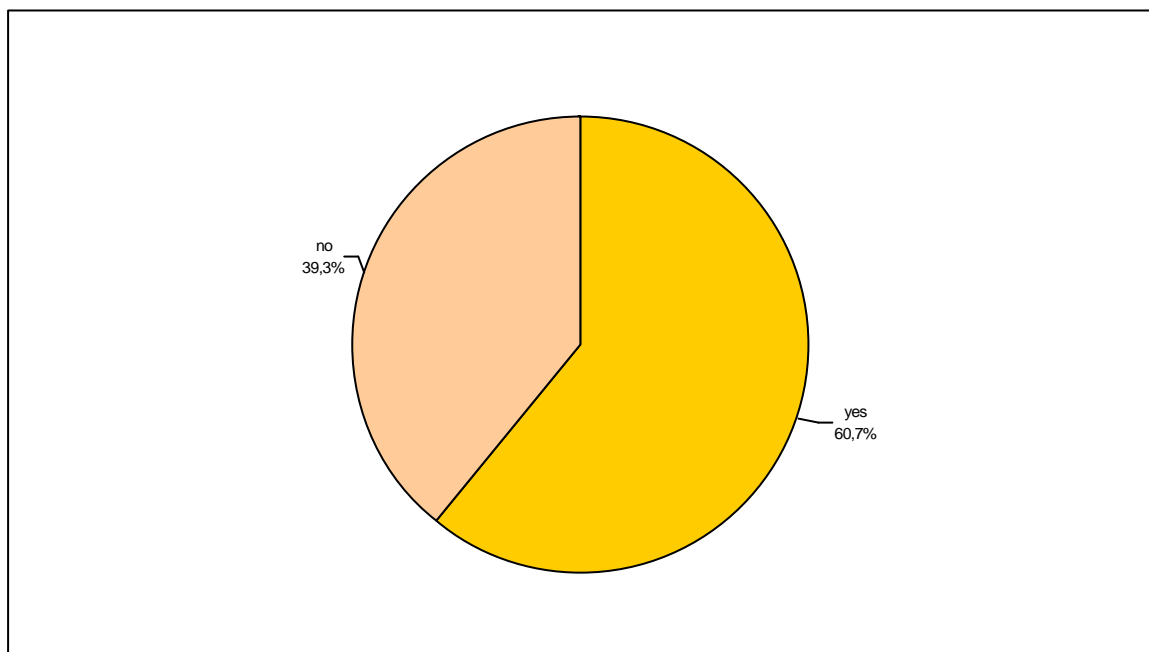


Chart 7. Are you planning to initiate a bond issue during the following months (of 2002)?

As the existing centralized data shows, 12 local communities contracted loans during October - December 2001 (including big cities). The total value of the contracted loans was of 934,000 million lei (approx. 350,000 USD). Two of them have chosen a bond issue (Predeal and Mangalia), and the other ten's option was to contract loans from commercial banks. The most evident proof that the mechanisms are slowly becoming understood and assimilated by the local beneficiaries consists in the higher number of the 2002 contractors of loans (from commercial banks or bond issues). These loans were contracted during January - December 2002. Eight of them were bond issues to be reimbursed in 2007⁶. In the same period of time around 30 local communities have chosen banking loans.

As the data included in following Table 1 shows, the funds raised through the bond issues progressively increased while the interest rate decreased (see Chart 8). This situation could be explained through a bigger confidence the banks started to have in the system, more local government units experiencing the bond issue activity. Another conclusion that can be drawn analyzing the data included in the table is that most of the municipalities that

issued bonds were originary from Transylvania. The only exceptions are Bacau (Moldova) and Mangalia (Dobrogea).

Table 1. Data regarding bond issue in Romania (the data is directly collected from the local authorities, no centralized situation being available).

Municipality	Number of inhabitants	Year of the bond issue	Number of issued bonds	Total of the gained funds	Interest rate
Alba Iulia (Alba county)	71,848	2002	160,000	16 billion lei (484,848.48 USD)	32%
Bacau (Bacau county)	208,643	2002	350,000	35 billion lei (1,060,606.06 USD)	26%
Breaza (Prahova county)	18,768	2002	15,000	3 billion lei (90,909.09 USD)	28,3%
Cluj-Napoca (Cluj county)	332,941	2002	250,000	25 billion lei (714,285.71 USD)	34,28%
Mangalia (Constanta county)	43,974 (summer resort)	2001	100,000	10 billion lei (312,500.00 USD)	36%
1 st bond issue by Predeal municipality (Brasov county)	6,646 (winter resort)	2001	50,000	5 billion lei (156,250.00 USD)	37%
2 nd bond issue by Predeal municipality (Brasov county)	6,646 (winter resort)	2002	75,000	7,5 billion lei (214,285.71 USD)	25%
Sebes (Alba county)	29,483	2002	10,000	10 billion lei (285,714.28 USD)	23%
Tîrgu Mures (Mures county)	164,132	2002	20,000	20 billion lei (571,428.57 USD)	23%
Zalau (Salaj county)	70,497	2002	100,000	10 billion lei (285,714.28 USD)	35%

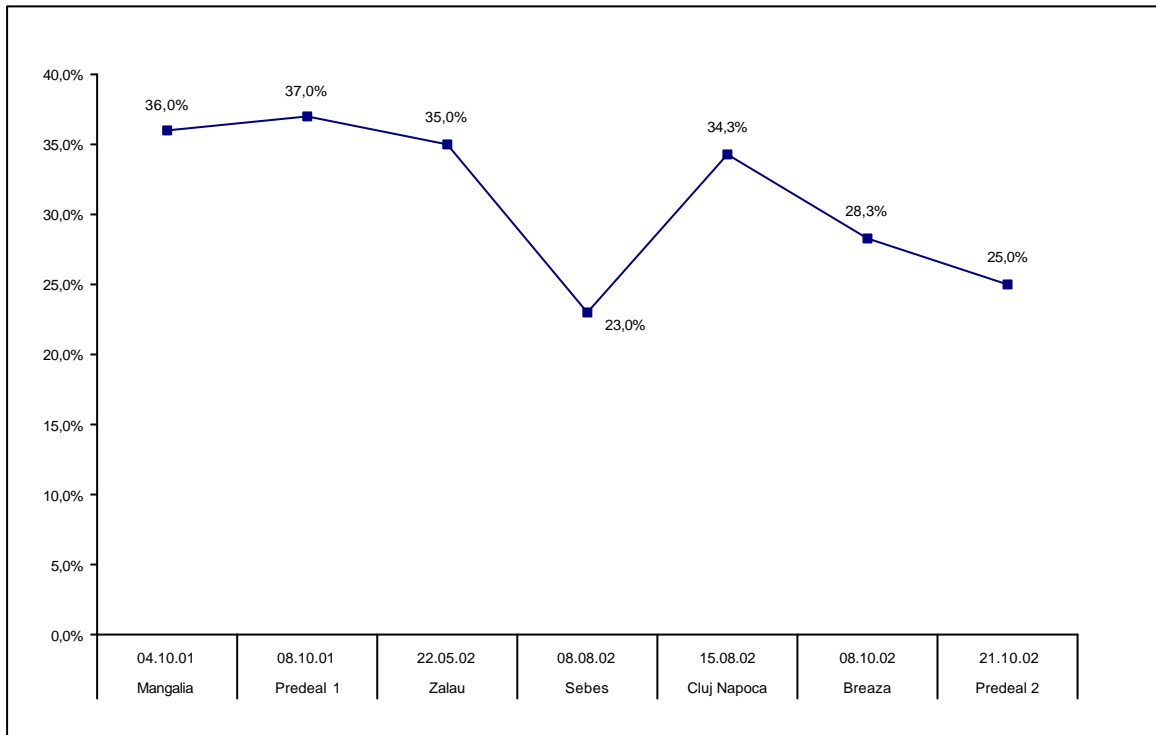


Chart 8. The fluctuation of the interest rates of bond issue in 2001 and 2002

The data presented in Table 1 and Chart 8 as well as other macroeconomic trends (e.g. the estimated inflation decrease) show that the bond market will not only be more attractive to the local communities but also more accessible.

The attitude of the local government units towards bank credits vs. bond issue

When analyzing other neighboring developed markets, which were expecting that the bank loans would predominate over the bond issue, one can easily notice that each country experience differs according to many factors. The local financial capacity, the banking solidity in a country are only some of these factors, the self trust of the local managers and their partnership with the local business community being, for example, other very important indicators. Anyway, in Romania, the two municipal bond issues successfully carried out in the fall of 2001 indicate that the capital markets were claiming for real financial investment instruments, resulting in local community lower borrowing costs that could have been achieved through bank lending.

Since the adoption of the Law on local public finances the number of the local government units which have contracted loans from commercial banks, was higher than the ones that have issued bonds. One possible explanation could be related to the more spread and more complete information regarding the loans procedures, the bond issues mechanisms remaining vaguely understood. Only recently promoting best practices became a preoccupation. Talking about mechanisms and procedures, steps towards contracting loans were easier understood by the local communities while the comprehensive mechanism of issuing bonds made some local actors continue to act reluctant.

Still, during the last years, many of the local authorities have been commenting the possibility of supplementing their local revenues through bond issues. The main reasons they invocated could be classified as follows:

- ? the interest rate was lower in the capital market than in the banking sector;
- ? the procedure for issuing bonds is less complicated than the one characteristic for contracting banking loans, the bureaucracy being considerably reduced in the case of the bond issue;
- ? best practices in the area of bond issues were constantly promoted through central and local media.

Regarding the capital spending, it should be noted that most of it is financed through internal or external borrowings. As repeatedly said in the report, the Law on local public finances does not allow local communities to use the loan funds for their operational expenditures. The experience of Romania so far has showed that the areas more financeable through borrowings are the public utilities (water providing utilities, street maintenance, water waste), the construction or the improvement of touristic objectives or market places. More various projects could become further financeable through this mechanism, as the local communities grow.

In both the case of contracted loans and bond issues a key element that contributes to the success of the borrowing process is the political commitment of the local public authorities. The community will benefit if the mayor and the local councilors have the same understanding of the local public interest and the correlated investment priorities. In the communities in which the mayor and the local councilors have different perspectives on the local development and where political disputes frequently occur, investment initiatives and the borrowing process might be affected.

If we are to consider a typology of the local communities that accessed local government borrowings, most of them are medium size municipalities whose economy is well developed. Also, many of them are touristic areas, local authorities closely collaborating with the local business environment. At the same time, small towns obviously don't have these advantages, the number of their contracted loans remaining small. On their turn, big cities became more attracted to experiencing external borrowings because these bring more substantial revenues.

On the other hand, we cannot speak about practices in managing insolvency of local government units yet as there is no case of bankruptcy or liquidation of local governments. This is partially explained by the fact that law provisions regarding the debt level (20% of the total current revenues) represent a protection factor in this respect and does not allow the local communities to borrow over their financial capacity. On the other hand, although the practice of local borrowing is still in its early stages, it is expected that these types of problems would occur, along with local borrowing development.

Accepting new mechanisms through which to supplement their local revenues, is finally directly depending on how informed the local authorities are to understand the whole process and obligations.

It is encouraging that the local authorities' attitude towards borrowing slowly evolved from fear of risk and mistrust (during the first two years after the adoption of the Law on local public finances) to a more positive perception of local government borrowing (starting with 2002). Although the number of the contracted loans is now bigger than the bond issues, some on field information indicates that the "popularity" of the latter is constantly growing among the local communities.

Recommendations:

- ? Best practices in the domain of bond issues and loans contracted from commercial banks should be further promoted so that local communities in Romania will trust more these financial instruments that are crucial for local development;
- ? Local communities should diversify the nature of the investment objectives, public utilities being the main target so far;
- ? Local public authorities should also orient their efforts towards improving relations with the local business environment, main creditors of the bond issues;
- ? In order to get involved in less risky financial activities of the local investments, local authorities should diversify the financial instruments. Our recommendation is to use the bond issue or commercial banks loans for co-financing investment projects.

IV. Conclusions

Contracting loans from the banks or partnershiping with citizens and companies in a borrowing process were not common practices in Romania. It took a while before being understood but they eventually became part of the daily life of many local communities these days. Eager to help developing their communities, local authorities have faced more and more severe budget constraints. First years after 1989, drafting policies according to planning the local communities' development was rather exceptional, many local authorities struggling to adapt to the new circumstances. Years after, it was the number of those local communities which wanted no development that became exception. Evolving from assisted to proactive development implementers, local communities became step by step very receptive to other means through which to supplement their local revenues. The more demanding they became, the more development oriented they were, the bigger the pressure on the central government to create the necessary tools with which local communities to increase their revenues.

In such a big country like Romania is, it is hard to generalize attitudes and experiences. The biggest communities, run by former managers trained in administrating people and funds, have soon become financially stable but, in reverse, more demanding to access more funds that will help them to grow further. A significant number of local authorities though remained assisted, the role of the central government, the State budget transfers - to be more explicit - continuing to be requested. It is important for such communities to be widely exposed to other neighboring experiences, to be helped (of course) but trained to replace the central government transferred funds with their own raised money. It involves risk management, predictability sense but also good management skills and, as we know from life, not everybody succeeds.

Local government borrowing is one of the most recent (and therefore still insufficiently explored) means through which local communities in Romania are aiming to raise additional funds for their development projects. Soon after '90s, learning that the central budget available sources will become limited, local communities have started to explore other less traditional means. First "temptation" was to increase but also diversify the local taxes. Increasing the taxes or inventing new ones was the new method, the closest to traditional means through which to finance local needs. It was when approaching the often not so traditional financial tools that some local authorities behaved reluctant about. It has become close to exaggeration how far some local authorities went while trying to increase their local funds in order to finance their development projects. Examples of local authorities imposing taxes on questions or interviews were earlier mentioned in this report. Despite the very questionable legality of such approaches, it is important to nominate them in order to describe the more and more serious need for extra State budget funds to cover the development projects. The State transfers will remain crucial for the operational activities costs of the local communities.

While other post-communist countries have made the borrowings as their daily, normal means channeling additional funds for their local communities, Romania has looked at both these options rather cautious. It is, we have to admit, a system protection towards change, a public institutions and authorities resistance towards risk that comes with the new. The always predictable financial system was for many people revolutionized by these two not so secure mechanisms through which to raise more funds.

It was, of course, a reaction to the lack of legislative tools in place but was probably more than this. Why are the local authorities still cautious when approaching the banks or, even more, when issuing bonds? How difficult it is for some of the local communities to assimilate the free market exercises, like for example approaching a commercial bank for a loan? Besides the legal framework, there are also other barriers that had a direct impact on the still small number of local authorities which tried to contract a loan or issue bonds. Some of these barriers are related to the insufficient experience and initiative of many local authorities in Romania. It has to be mentioned also that the public servants are not sufficiently trained in preparing and conducting the necessary documentation (for example drafting a business plan). Also, local authorities are still inexperienced in building medium and long-term strategies, which to give them a full picture of finances and investments for 3 to 5 years. It is only recent that the central government established the Institute for Public Administration whose main role is to train local and central elected officials as well as public servants. Training topics vary from human resources management to PR or EU accession requirements.

Many of the local authorities that were approached, explained the very hard, if not impossible, multi-year budget predictability. Still dependant on yearly budgeting, local communities that felt ready to contract ambitious development projects have to advocate more the central government to adopt such profound new budgeting philosophy. Very concerned with the financial discrepancies between local communities, central government finds safer to annually supervise the financial process at the local level. Different and sometimes too different levels of development between communities from two distinct areas in the country has been Romania one of the continuous concerns whenever analyzing the central government role in relation with the local communities. In a more and more competitive race for additional funds to finance development projects with, it is very hard these days to distinguish between the importance and the implications of the concepts such as subsidiarity, solidarity, etc. There are many values Romania have recently learnt about and many questions to still answer to, while deciding its future development priorities.

A direct consequence of local financial growth and of many more local authorities who have become frequently exposed to counterparts' experience, the bond issues and the loans' contracting have slowly but seriously integrated in the Romania market. No statistics about how evolved these first local communities experiencing such practices were, would be available. Obviously the economic development (both in terms of local revenues and well developed business community) was one key criteria. In reality, these

well advanced local communities have not only started to prove it was working but they were the ones whose advocacy lead to improving the legal framework to easier the future experiences.

No doubt the several years of experience by now, were not enough to draft a perfect legislation, local authorities reunited in a Local Authorities Federation of Romania still lobbying for future amendments. A multi-level working group formed of representatives of the Ministry of Finances, Ministry of Public Administration and local authorities have analyzed the opportunity of amending the legislation. The necessary amendments of the legal framework that will make possible the local access to other sources of funds is only one part of a more comprehensive local public administration reform that is currently implemented.

The main legislation regulating the topic of our interest should be also correlated with all complementary legal provisions. Local budgets need to become predictable in order to plan the reimbursement to a bank or to be able to compensate the community borrowed contributions. In this sense, it is imperative that the fiscal decentralization process continues. More financial resources should be transferred to the local communities so they would have the real local autonomy to design and implement the necessary policies. A more realistic correlation between fiscal decentralization and responsibilities' assignment is also very important. Local authorities should not have only the responsibility and the financial resources transferred but they should also be entitled to make decisions about how the local public services are administered and therefore how the money is locally spent.

Strengthening the local finances, equipping the local authorities with the necessary legislative tools but also with the minimum exposure to others who previously borrowed from the population or contracted a loan, is very important for the future growing of Romania local communities. Familiarizing the local authorities with new means through which to supplement their revenues should rely on a solid self-confidence in the project, and that it is first the local authorities that should take the responsibility for it. All this comprehensive process should move in parallel with a real, complete transparency of all other channels possibilities that the central government uses whenever to financially help the local communities; with transparent criteria and methodology in distributing the Ministers' "special funds". All these are very important in a fair relation between central and local authorities. In this context, it is also very important to raise awareness about the long term institutions consolidation threat represented by politics interfering the administrative decision making at any level.

The two financial instruments that were largely debated in this report: loans from commercial banks and bond issues, seem to be the less exposed to political interference although there were examples indicating that is not so impossible to influence banks' transactions in Romania, to give but one example.

The politization of the local public administration in Romania has a major

influence on the way the local community is administered. It affects various aspects of local public management including the local budget formation and, of course, the spendings, the setting up of the investment priorities and the way local partnerships are formed. Immediate steps that need to be taken are the adoption of clear rules regarding the conflict of interest at local level as well as to strengthen the insubordination relation between different levels of government by reducing, if not eliminating, the influential role of the county council president in the local budgets equalization process.

The improvement of the situation presupposes a double effort. While central authorities should be the main responsible in the legislative improving process, local communities (both counties and municipalities) should have an increased role in supplementing their own revenues, as local development is dependent on investments that could be mainly financed through local borrowings. Local authorities should become more proactive, ready to take the action after learning the risks, while central authorities should offer a proper legal environment in this respect.

Local authorities in their new more self-responsible position, bring the local reality to the Bucharest based top decision-makers, while these political leaders should listen more (in a more systematic manner also) to the local authorities needs and problems before adopting decisions. The role of the Local Authorities Federation (the legal structure reuniting Romania Municipalities Association, Romania Towns Association and Romania Communes Association) to which a number of specialized groups (the Association of the County Councils' Economic Directors, the Association of the County Councils' Secretaries, the Association of the County Councils' IT Specialists, etc.) are affiliated, should be irreplaceable in the legislation and practices' improvement process.

It is obvious that the local community cannot and should not be separated from the central government, since there are continuous mutual inter-connections. In terms of development, a stable, predictable macroeconomic development and the growing number of foreign investors as well as of the domestic business will directly influence the confidence that issuing bonds, for example, will be a successful decision for a local authority to adopt, if to finance a development project.

From what it was said above, both mechanisms through which to supplement local revenues place the local authorities in a new position and require new skills they have never had why to develop before. Local authorities acting in relation with the business community (be that the commercial bank or the local businessmen to attract in a borrow) is such a new challenge some local authorities treat it seriously, local authorities learning to understand its values and principles of a world that was before totally separated from them. It is no longer the exclusive role of the central government to deal with private investors, it became more a locally based direct relation between local authorities and businessmen together concerned with the development of the community.

Partnershiping with the business is crucial for the success of the two mechanisms the current report has been talking about. In the end, without suggesting it is the least important, involving citizens became an even more complex challenge for the local authorities. The topic of citizens as participants in a borrowing operation/activity is no longer an absurdity but, for this to happen, local authorities (the ones seeking for citizens' implication) need to learn the necessary mechanisms and skills.

Involving citizens in such complex transformations, making them to contribute in a project development, means that they trust the project but they also trust the local authorities, which it needs more work in Romania. According to all last opinion polls citizens' confidence in their elected representatives dramatically decreased.

All these actors in the community that were again mentioned in the *Conclusion* section, should have one common goal: the development of the community for the sake of all living in it. No development project will succeed if no appropriate legal tools are designed and in place, if no sense of responsibility, no mechanisms to predict the revenues and to plan the spendings exist. And yes, the role of the central government has changed along with the new expectations from the local officials but no local development project (and ultimately no national development project) will succeed if the two don't complement each other, both of them involving all important interested partners: citizens, business community from inside and abroad. In the current European oriented circumstances, Romania is going through a very complex reform process that, no doubt, has made of the local communities (the ones that are the closest to the citizens) one important priority.

The final goal of the public administration reform should be the building of strong, powerful, independent local communities with solid budgets and capable of providing high quality services to the citizens. These can be achieved only if the necessary responsibilities and instruments are available (the local government borrowing being one of them). When the necessary tools are in place, it is expected that local communities in Romania would take charge of all local matters, designing and implementing policies that will further stimulate the local development.

Notes

¹ The capital is the biggest municipality within the county and the headquarter of all county public institutions,

² Equalization funds - non earmarked funds allocated from the state budget to local communities in order to conduct a horizontal and vertical equalization of budgetary revenues.

³ Special taxes are collected with a specific purpose and the revenues are spent according to their initial destination

⁴ Partners for Local Development Foundation (2002), Fiscal Policies to Improve the Local Government Revenue Assignment correlated with Responsibilities' Assignment, Bucharest, page 15,

⁵ Institute for Public Policy (2002), practical guide *Local Budgets. How Local Communities Supplement Own Revenues*, Bucharest, page 47,

⁶ Institute for Public Policy (2002), practical guide *Local Budgets How Local Communities Supplement Own Revenues*, Bucharest, page 40,

⁷ Two more local communities issued municipal bonds (one of the bond issue, the one of the Bacau municipality, was of 1 million USD) in December 2002.

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